Supreme Court, U. S.
FILED
MAR 12 1980
MICHAEL RODAK, JR., CLERK

No. 79-1149

In the Supreme Court of the United States

OCTOBER TERM, 1979

ALLSTATE SAVINGS and LOAN ASSOCIATION, ETC.,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNTIED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

WADE H. MCCREE, JR.
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The question presented in this federal income tax case is whether the decision below correctly held that expenses incurred by a bank in selling property it had acquired by foreclosure can be taken into account only by way of adjustments to the reserve for losses from real property loans, pursuant to Section 595 of the Internal Revenue Code of 1954 (26 U.S.C.), and are not separately deductible as business expenses under Section 162 of the Code.

The pertinent facts are undisputed and may be summarized as follows: During 1968 and 1969, petitioner's predecessor (Metropolitan Savings and Loan

Association) reported its income on the cash receipts and disbursements method of accounting, and used the reserve method in computing its bad debt losses, pursuant to Sections 593 and 166(c) of the Code. Its principal activities in these years were acquiring cash savings from the public and lending money. Most of its loans were secured by real property (Pet. App. 6).

During this period, a number of Metropolitan's borrowers defaulted in the payment of real property loans. In order to collect on these defaulted loans, Metropolitan was required to institute foreclosure proceedings to acquire the property securing the loans. In each instance of foreclosure, Metropolitan acquired the secured property through nonjudicial foreclosure, usually by exercise of a power of sale granted under terms of a deed of trust. Once it acquired property through foreclosure, Metropolitan attempted to sell it as soon as possible in order to maximize recovery on the loans for which the property served as security[1] (Pet. App. 6-7).

In 1968, Metropolitan sold 40 tracts of foreclosed real estate at an aggregate selling price of $4,262,000, and incurred brokerage commissions of $223,546 on those sales. During 1969, Metropolitan sold 17 tracts of foreclosed real estate at an aggregate selling price of $1,532,593, and incurred direct post-foreclosure expenses[2] of $37,764, including brokerage commissions of $11,753 (Pet. App. 7).

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[1]Under California law, the property acquired by Metropolitan was the sole security for the underlying loan, and the borrower was not accountable to Metropolitan for any expenses paid or incurred by it subsequent to foreclosure (Pet. App. 7).

[2]The post-foreclosure expenses incurred by Metropolitan, in addition to brokerage commissions, included title costs, escrow fees bonds, and inspection fees (Pet. App. 7).

On its tax returns for 1968 and 1969, Metropolitan deducted the brokerage commissions and the other post-foreclosure expenses as ordinary and necessary business expenses under Section 162(a) of the Code. On audit, the Commissioner determined that these expenses were not directly deductible under Section 162 but, rather, were required, under Section 595, to be taken into account through Metropolitan's reserve for losses on real property loans. In this suit brought by petitioner (as Metropolitan's successor), the Tax Court sustained the Commissioner's determination. In so ruling, the Tax Court expressly rejected petitioner's contention that the Treasury Regulations promulgated under Section 595 permitted Metropolitan's selling expenses to be deducted under Section 162 (Pet. App. 9-26). The court of appeals affirmed (Pet. App. 1-4).

1. The decision below correctly held—in this case which petitioner acknowledges to be one of first impression (Pet. 2)—that Metropolitan's selling expenses are not separately deductible under Section 162 of the Code but are required by Section 595 to be taken into account through appropriate adjustments to its bad debt reserve. Section 595 deals with the tax consequences to a savings and loan association resulting from the acquisition of property by foreclosure and from the subsequent disposition of such property. Pursuant to that provision, the acquisition of property by foreclosure is not a taxable event. Moreover, the acquired property takes on the character of the underlying indebtedness, and any amount received on the disposition of the property is treated as a payment on account of the indebtedness. Section 595(b). The gain or loss realized on the disposition of the property (computed by comparing the amount of the sales proceeds to the amount of the indebtedness) is then

credited or charged, as the case may be, to the association's bad debt reserve. See Treasury Regulations on Income Tax, Section 1.595-1(e)(6) (26 C.F.R.).[3]

As the Tax Court correctly pointed out (Pet. App. 14-15), the amount of gain or loss realized, and hence the proper credit or charge to the reserve account, can be correctly determined only if the costs incurred in disposing of the property are taken into account. The amount of such expenses is an indispensable factor in reconciling the unpaid loan balance with the results of the disposition of the foreclosed property so as to determine the extent to which gain or loss has been incurred on the overall series of transactions (*i.e.*, loan, foreclosure, and sale of foreclosed property). Quite obviously, if the selling expenses are ignored, the actual gain or loss realized will be distorted, producing a corresponding distortion in the reserve account.[4]

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[3]Prior to the enactment of Section 595 as part of the Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960, the foreclosure of property by a savings and loan association was a taxable event, resulting in gain or loss where the fair market value of the foreclosed property was greater or less than the price at which it was bid in. Moreover, the subsequent sale of the foreclosed property constituted another taxable event, with the association recognizing capital gain (or loss) or ordinary gain (or loss), depending on whether the foreclosed property was a capital asset in the association's hands, or property held "primarily for sale" in the ordinary course of business. See S. Rep. No. 1881, 87th Cong., 2d Sess. 47-48 (1962). Section 595 was intended to telescope the foreclosure, purchase, and resale of the security property into a single taxable event, and to require the gain or loss from the single taxable event to be taken into account by a credit or charge to the taxpayer's reserve for losses (*ibid.*).

[4]It is well recognized that selling expenses are as much a part of the cost of the asset sold as is the price paid for it. *Woodward* v. *Commissioner*, 397 U.S. 572, 576 (1970); see also *United States* v. *Morton*, 387 F. 2d 441, 449 (8th Cir. 1968); *Page* v. *Commissioner*, 524 F. 2d 1149 (9th Cir. 1975); *Of Course, Inc.* v. *Commissioner*, 499 F. 2d 754 (4th Cir. 1974).

The correctness of the decision below is further demonstrated by the Code's treatment of expenses incurred in acquiring security property through foreclosure. Section 595(c) provides that such acquisition costs are to be added to the taxpayer's basis in the acquired property and thus taken into account in determining the gain or loss on the subsequent disposition of that property. Since the costs incurred in selling foreclosed property do not differ significantly from those incurred in initially acquiring such property, selling expenses should be similarly reflected in the computation of the gain or loss realized.

2. Petitioner contends (Pet. 16-19) that the Regulations promulgated under Section 595 establish that selling expenses are separately deductible under Section 162 where, as here, the debtor is not accountable for those expenses under local law. But, as the Tax Court correctly pointed out (Pet. App. 22-25), petitioner's interpretation of the regulation is erroneous. Section 1.595-1(e)(7) of the Regulations states that Section 595 does not change the treatment of expenses incurred by a savings association with respect to property acquired by foreclosure. While petitioner construes this provision as encompassing expenses incurred in selling such acquired property, the examples in Section 1.595-1(e)(8) of the Regulations, which illustrate the intended scope of Section 1.595-1(e)(7), show that the latter provision addresses only those expenses incurred during the interim period between the foreclosure and the subsequent sale of the property.

These examples, which do not refer to selling expenses, indicate that the treatment of expenses and income realized during the interim period between foreclosure and sale is dependent upon the accountability of the respective parties for those items under local law. The examples thus properly recognize that where a savings

institution takes over the operation of income-producing property, it is engaging in a business activity separate and apart from the original loan transaction, and that the expenses and income realized in this regard should be reported accordingly, rather than under the special rules of Section 595. Of course, where there is accountability for the expenses and income under local law, then these items necessarily relate to the original indebtedness and must be accounted for in accordance with the provisions of Section 595.

Under the basic statutory scheme of Section 595, however, the sale of foreclosed property in *every* case relates back to and is part of the original loan transaction, because the amount received from the sale is measured against the amount of the indebtedness to determine whether a gain or loss has been realized on that loan transaction. The absence or presence of accountability in no way alters the fact that the costs incurred in disposing of foreclosed property (like the similar costs of acquiring such property) reduce the amount available to be applied against the underlying indebtedness, and thus reduce the amount of gain, or increase the amount of loss, as the case may be, which otherwise would have been realized. There is accordingly no basis for petitioner's position that selling expenses are included under Section 595 in determining gain or loss where the debtor is accountable for the expenses but are excluded in making that determination where there is no accountability.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

MARCH 1980